BANCA PROMOS

# Italy towards the infraction procedure

## Causes, steps, protagonists and sanctions of a tortuous process


**Banca Promos**
**Investment Banking Desk**

**Alessandro Sica**
*Analyst*

+39 081 01 70 622
alessandro.sica@bancapromos.it
investment.banking@bancapromos.it

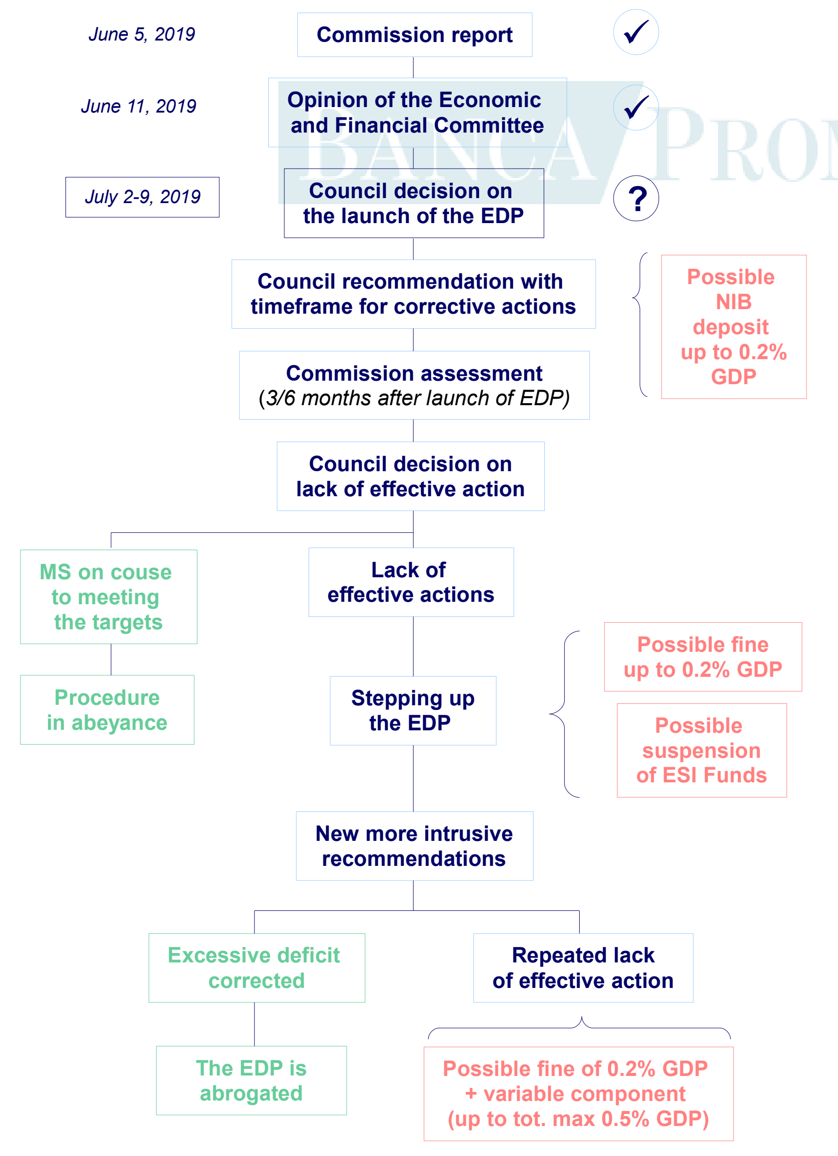
**Paolo Cozzolino**
*Managing Supervisor*

+39 081 01 70 617
paolo.cozzolino@bancapromos.it
pcozzolino2@bloomberg.net


**About six months have passed since Italy has succeeded in avoiding the launch of an Excessive Deficit Procedure** (EDP) due to the breach of the debt rule (back then, we published a report to provide an overview of the Stability and Growth Pact (SGP), of which the EDP is the so called corrective arm).

**Now**, after the European elections and given the increase in public debt from 2017 to 2018, **the launch of an EDP is once again a possibility**. The first two 'preparatory' steps of the process have already been completed. **It is** therefore **up to the ECOFIN, on a proposal from the Commission, to decide** whether or not to start the actual procedure.

### A tortuous path




*Source: European Commission, European Parliament, Osservatorio CPI*

### EU upcoming events

**2019**

**July 1**
End of mandate: Antonio Tajani (European Parliament President)

**July 2**
Inaugural plenary session of the new European Parliament

**October 31**
End of mandate: J.C. Juncker (Commission President)

**October 31**
End of mandate: Mario Draghi (ECB President)

**November 30**
End of mandate: Donald Tusk (European Council President)

**December 31**
End of mandate: Benoit Coeure (ECB Executive Board)

**2020**

**June**
End of mandate: Mario Centeno (Eurogroup President)

**December**
End of mandate: Yves Mersch (ECB Executive Board)

*Source: European Parliament, ECB, Bloomberg*


**On the same topic:** *(in Italian only)*

**The Excessive Deficit Procedure**

An overview of the Stability and Growth Pact

*October 5, 2018*

## Preface

**Negotiations** between the Italian government and the European Commission **are underway to prevent the initiation of an infraction procedure** for excessive debt. As already happened in December 2018, **it is possible that these talks will end with** an agreement and **the postponement of the discussions to the autumn** when the next budget law will be defined. At that point, the key topic would become the higher than 23 billion euros VAT increase that the government want to avert.

The press, especially the international one, has paid much attention to Mini-BOTs, seen as a premise for Italy's exit from the euro. **More concealed**, and predominantly within national borders, **newspapers mull**, instead, **about a possible** *patrimoniale* (ie a **wealth tax**).

Whatever the outcome of the European confrontation, **indeed, it remains a fundamental theme**, namely that of a State burdened by a debt greater than 130% of GDP, whose **citizens have a net wealth of 9,743 billion euros** (2017), over 4 times the public debt.

Wealth taxes are not new to Italy. **The most illustrious precedent is the 6‰ forced withdrawal** from Italians' bank accounts **decided by the Amato cabinet** on the night of July 10, 1992. **But also the Monti cabinet**, at the height of the European sovereign debt crisis, **intervened, with the IMU tax**, on the major component of Italians' wealth: dwellings.

Deputy Prime Minister, **Matteo Salvini**, **has** recently **proposed** the idea **of bringing out the cash deposited in safe-deposit boxes** (from about 50 to 200 billion euros, according to some estimates), hastening to point out, however, that this would not be a wealt tax but rather a 'fiscal peace' (an amnesty).

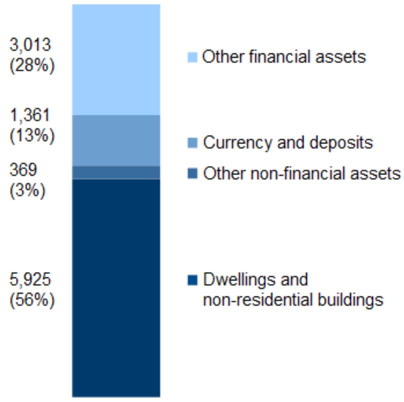
Anyway, **as of now, the focus remains on the outcome of the European negotiation**, to be monitored bearing in mind the new interest rate environment in the euro area emerged from Mario Draghi's words in Sintra, but also the recent statements by the French economist Jean Pisani-Ferry: "*The Commission is right to alert Italy, but we must not make a mistake in diagnosis. In fact, for twenty years, Italy has lacked growth, not budgetary rigor. If France had followed the budget policy of Italy, its debt would be only 45% of GDP*".

### Italy: debt-to-GDP ratio

| | 2018 | 2019 | 2020 |
|---|---|---|---|
| **Government** (*April 9, 2019*) | 132.2% | 132.6% | 131.3% |
| **Commission** (*May 7, 2019*) | 132.2% | 133.7% | 135.2% |
| **IMF** (*April 9, 2019*) | 132.1% | 133.4% | 134.1% |
| **S&P** (*April 26, 2019*) | 130.2% | 131.7% | 132.0% |

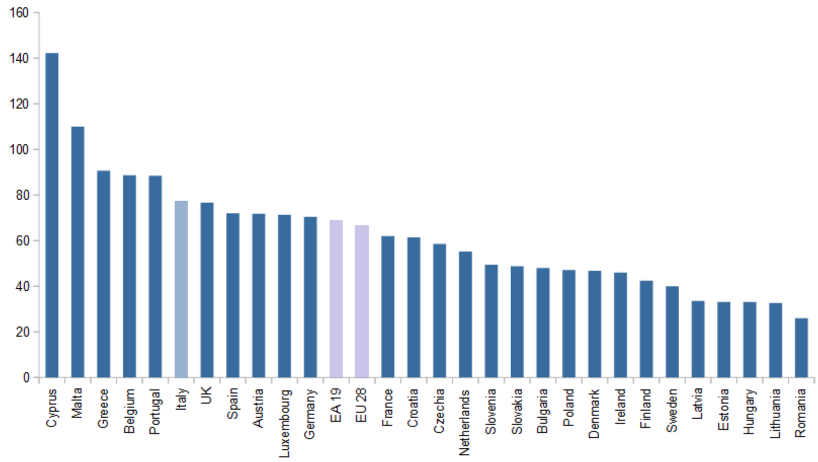
*Source: Government, European Commission, IMF, S&P*

### Italy: households' gross wealth in €bn (2017)



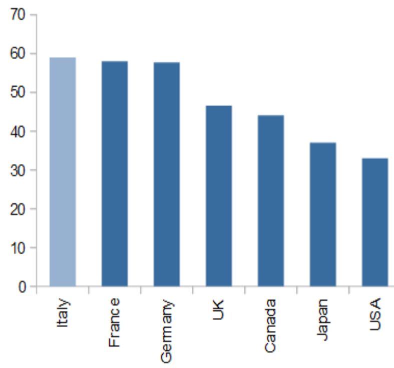

*Source: Bank of Italy, Istat*

### Households' currency and deposits as a % of GDP (2017)




*Source: Eurostat*

### Households'non-financial assets as a % of gross wealth (2017)




*Source: Bank of Italy, Istat, OECD*

## The debt rule

*Two criteria, one procedure*

**The Excessive Deficit Procedure** (EDP) is governed in its main features by Article 126 of the Treaty on the Functioning of the European Union (TFEU, 2007). Although its name refers only to excessive deficits (ie greater than 3% of GDP), the procedure **can be triggered also in the face of excessive public debts**. Italy is deemed to be breaching this second criterion. If initiated, it would be the first EDP based on the infringement of the debt rule in more than twenty years of history of the SGP.

Indeed, **Italian public debt is more than twice the 60%-of-GDP EU threshold and it is not decreasing enough**. Under the SGP, its decline would be considered satisfactory if the gap between the actual Italian debt-to-GDP ratio and the 60% target was reduced on average by 1/20 of its amount each year (over the last 3 years or the following 3).

## Steps, votes and sanctions

**The breach** (or the risk of violation) of at least one of the two criteria (deficit or debt) **requires the Commission to prepare a report** aimed at assessing the case for launching an EDP. **The Economic and Financial Committee is called to formulate an opinion** on this report and to send it to the Commission.

**Italy: rating calendar**

| Date | Agency | Rating | Outlook |
|---|---|---|---|
| 07/12 | DBRS | BBBh | Stable |
| 08/09 | Fitch | BBB | Negative |
| 09/06 | Moody's | Baa3 | Stable |
| 10/25 | S&P | BBB | Negative |
| 11/15 | DBRS | BBBh | Stable |

*Source: Reuters*

**On June 5, the Commission has published its report about Italy**. At the base of the report there is the dynamics of the debt-to-GDP ratio, which reached 132.2% in 2018 from 131.4% in 2017 (thus increasing instead of decreasing). The expectation of both the Italian government and the European Commission is that the ratio will rise in 2019 too (to 132.6% and 133.7% respectively).

**On June 11, the opinion of the so called 'sherpas' of the Economic and Financial Committee has been expressed too**. Their view is that the debt criterion is not respected and Italy is invited to take the necessary measures to ensure compliance with the indications of the SGP.



At this point, **if the Commission thinks that an excessive imbalance exists** or may occur, **it** transmits its opinion to the MS and **informs the Council**. The opinion of the Commission about Italy is expected on **July 2**.

**The Council**, on a proposal from the Commission and considering the remarks of the MS concerned, **decides whether the excessive imbalance exists or not**. **If so, the EDP is officially launched**. The date of this decision could be **July 9**.

With reference to the votes of the SGP, **the MS directly concerned does not vote** and the MSs that don't belong to the euro area do not participate if the vote concerns a euro-area MS.

**Council votes** on Commission proposals **are** generally **taken by qualified majority. The majority is considered achieved if 55% of the MSs participating in the vote, representing at least 65% of the overall population of the MSs themselves, is in favor of the Commission's proposal.**

**The Council**, on the recommendation of the Commission, **addresses a recommendation to the MS**, that is it defines the timeframe within which the MS concerned will have to achieve specific (nominal and structural) targets to correct its budgetary imbalances.

**The MS** undergoing the EDP **has 6 months** (3 in the case of serious violations) **to start taking effective actions** to deal with its imbalance, thus complying with the recommendations received from the Council and the Commission.

Euro-area **MSs** already sanctioned under the preventive arm of the SGP or whose violations are particularly serious, **can be sanctioned**, already at this stage, **with the payment of a non-interest-bearing deposit up to 0.2% of GDP**. **The decision rests with the Council, which votes by reverse qualified majority: the sanction, proposed by the Commission, is approved unless it is opposed by a qualified majority of voting countries ('semi-automatic' mechanism).**

At the end of the first deadline of 6 (or 3) months, **the Commission and the Council evaluate the effectiveness of the actions taken by the MS** and decide whether to suspend the procedure or to step it up.

**An EDP in abeyance is still subject to a continuous monitoring** and can be reactivated if the MS moves away from compliance with the recommendations received.

**If the MS has** taken effective action to address its imbalance but its finances have **suffered the impact of exceptional events**, outside its control, **it could benefit from an extension of the deadline** and a revision of the recommendations.

**If**, on the contrary, **the MS has not acted effectively** to correct its imbalance, **it will receive new, more intrusive recommendations** and a new timeframe. **In this scenario**, for euro area MSs, **the Commission may propose the imposition of a fine of up to 0.2% of GDP**. This sanction, like the non-interest-bearing deposit, is voted by the Council by a reverse qualified majority.

**Furthermore**, for all MSs (also non-euro-zone members), **the Commission may propose the** partial or total **suspension** of the commitments and payments **of the European Structural and Investment Funds** (ESI). The suspension of ESI committments is approved by reverse qualified majority whereas the suspension of ESI payments is voted by ordinary qualified majority.



**Repeated non-compliance** by the MS **can bring the fine up to 0.5% of GDP**, by adding a variable component to the pre-existing fixed component. This sanction must be approved by an ordinary qualified majority.

**The EDP is abrogated only when the imbalance is permanently corrected and the debt rule is respected in a forward-looking perspective**. The repeal requires a Council decision adopted by qualified majority, on the recommendation of the Commission. At this point, the non-interest-bearing deposit is returned to the MS (but not the fines paid) and ESI Funds are released.

## Key institutions

### Italian government

In office since June 2018, it is the outcome of a coalition between Luigi di Maio's Five Star Movement (219 seats in the Lower House and 106 in the Upper House) and Matteo Salvini's League (123 seats in the Lower House and 58 in the Upper House). European elections in May 2019 – with the League at 34% of the votes and the 5SM at 17% – have reversed the balance of power in the cabinet. Negotiations with the EU are led by two of the most 'technical' and moderate representatives of the government: the Prime Minister, Giuseppe Conte, and the Minister of Economy and Finance, Giovanni Tria.

### European Commission

The executive body of the EU is made up of 28 commissioners, one for each MS. Currently chaired by Jean-Claude Juncker (Luxembourg), its renewal is expected no later than the end of the year. Pierre Moscovici (France) is Commissioner for Economic and Financial Affairs, Taxation and Customs. Valdis Dombrovskis (Latvia) is Vice-President responsible for Euro and Social Dialogue, also in charge of Financial Stability, Financial Services and Capital Markets Union.

### Economic and Financial Committee

It expresses opinions at the request of the Council or the European Commission (or on its own initiative), provides the framework for dialogue between the Council and the ECB, contributes to the preparation of the Council's work. It is composed of senior officials from national administrations and central banks, the ECB and the Commission.

### ECOFIN

One of the 10 different formations of the Council of the EU. It coordinates the economic policies of the MSs, promotes the convergence of their economic results and monitors their budget policies. It consists of the ministers of economy and finance of all MSs. The relevant European commissioners also participate in its sessions (generally one a month).

*Source: European Commission, Council of the EU, European Parliament*

## Precedents

*Flexibility and discretion*

**In 2003, the Commission recommended to the Council the launch of an EDP against France and Germany** for the violation of the 3% threshold of the deficit-to-GDP ratio for 3 consecutive years. **However**, during its meeting on November 25, 2003, **the Council didn't reach the qualified majority necessary to confirm this indication**: only the Netherlands, Austria, Finland and Spain voted in favor. **The Commission took the case to the Court of Justice of the EU** which, in July 2004, decided to annul the Council's conclusions.

Since then, the SGP has been repeatedly amended – firstly in 2005, then in 2011 with the Six Pack and finally in 2013 with the Fiscal Compact and the Two Pack – by introducing new rules and elements of flexibility.

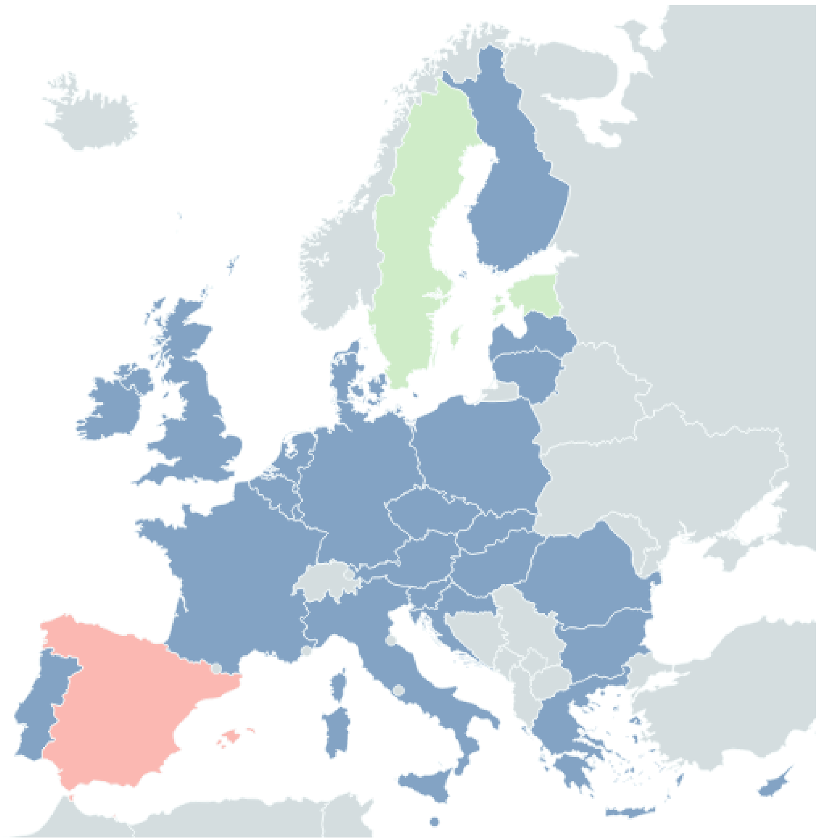
**In the summer of 2016**, **the Commission itself has proposed** to the Council **not to impose sanctions on Spain and Portugal**, although none of the two States subject to an EDP had taken sufficient actions to reduce deficit below 3% of GDP. **The Council agreed to the proposal**, giving the two MS more time to correct their imbalances.

Portugal's EDP has been closed in June 2017, while Spain is about to leave it in the near future. On June 5, 2019, in fact, the Commission recommended the repeal of the procedure launched against Madrid, laying the foundations for the closure of all the EDPs activated during the years of the financial crisis.

Both the French-German and the Spanish-Portuguese cases have recently been mentioned by the outgoing President of the European Commission, Jean-Claude Juncker, on the occasion of the ECB Forum in Sintra, as examples of the flexible and discretionary approach of both the Commission and the Council in the application of EU fiscal rules.



**EU Member States and EDP**
Sweden and Estonia are the only always-virtuous MSs



Legend: **Closed EDP**, **Ongoing EDP**, **No EDP**

*Source: European Commission*

## Conclusions

*A credit-positive EDP?*

Just six months after the last confrontation, the Italian government and the European institutions are once again debating the sustainability of Italy's finances.

**The League-5SM cabinet is weakened by numerous and frequent internal disagreements** and it is not clear how long Matteo Salvini will wait before capitalizing at the national level the EU electoral exploit.

**The European Commission is close to the end of its mandate** (on October 31). If for some observers this makes it politically 'weak', for others it makes it less 'constrained' and therefore more inclined to recommend an EDP.

The first line of thought is shared, among others, by **Romano Prodi**, former President of the European Commission from 1999 to 2004, **according to which the current moment of transition could favor a postponement of the procedure to October**, when more precise budget figures will be available. However, Prodi himself highlights the very strong irritation of some commissioners towards Italy.

An irritation that emerges, for example, from the statements of **Gunther Oettinger,** European Commissioner for Budget and Human Resources, **according to which, if Italy does not satisfy the requests of the Commission** on the 2020 budget, **there would be no room for maneuver to avoid the procedure.** Italy, the German commissioner has recently said, should think twice before disappointing the expectations of the EU.

**As for the ECOFIN**, the ultimate responsible for the decision, **the impression is that the majority** (if not all) **of the MS governments** and finance ministers **is closer to the positions of the Commission** than to those of Italy.

**Although, at first sight, the most reassuring outcome would be that of an agreement** that avoids the start of the EDP, **according to some observers the opening of the procedure could prove to be 'credit positive'** for Italian sovereign bonds.

**The entry of the country into a path of careful monitoring** of its public accounts by the EU **could reassure its creditors** (especially international ones) due to the expectation of more conservative budget policies.

**This scenario**, on the other hand, **could lead to a political crisis** and a new phase of uncertainty, for the formation of a technical government or the calling of early elections. **During this phase**, as usual in the EU, **the infraction procedure would be** temporarily **suspended**.